

Message Text

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FM SECSTATE WASHDC
TO AMEMBASSY OTTAWA IMMEDIATE

C O N F I D E N T I A L STATE 060183

DELIVER TO AMBASSADOR AT OPENING BUSINESS MARCH 9

E.O. 11652: GDS

TAGS: ENRG, CA, US

SUBJECT: CAPITAL COSTS OF NORTHERN GAS PIPELINE

1. FOLLOWING IS PROPOSED TEXT OF LETTER FROM SMITH, FERC,
TO EDGE, NEB, PROPOSING RESOLUTION OF CAPITAL COSTS
DISPUTE ON 56-INCH NORTHERN GAS PIPELINE. REQUEST
AMBASSADOR ENDERS REVIEW PROPOSED TEXT AND COORDINATE BY
TELEPHONE WITH ASST. SECY. BERGOLD AND FERC COMMISSIONER
SMITH NO LATER THAN 0930 MARCH 9. STATE DEPT HAS NOT YET
CONCURRED IN LETTER AND TEXT SHOULD NOT BE DELIVERED WITH-
OUT SUBSEQUENT STATE AUTHORIZATION.
2. BEGIN TEXT:

AT YOUR DIRECTION, WE WERE PROVIDED A COPY OF THE FOOTHILLS
PIPE LINES (YUKON) LTD. LETTER OF MARCH 3, 1978, WHICH
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DISCUSSES ITS CAPITAL COST ESTIMATES FOR THE PIPELINE IN
CANADA, WITH A 56-INCH, 1080 PSIG SECTION BETWEEN WHITEHORSE
IN THE YUKON TERRITORY AND THE BIFURCATION POINT NEAR
CAROLINE JUNCTION IN ALBERTA. FOOTHILLS HAS RE-E;STTMATED
THAT THE ADDITIONAL COSTS OF A 56-INCH SYSTEM OVER THOSE OF
THE 54-INCH SYSTEM CONTAINED IN ANNEX III OF THE AGREEMENT
ON PRINCIPLES BETWEEN THE U.S. AND CANADA ARE \$91 MILLION
IN ESCALATED DOLLARS. THIS FIGURE COMPARES TO FOOTHILLS'

FEBRUARY 27, 1978, ESTIMATE OF \$94 MILLION, WHICH INCLUDED

AN ADJUSTMENT OF \$38 MILLION (\$24.2 MILLION IN CONSTANT 1976 DOLLARS) TO THE FILED COST ESTIMATES WHICH ARE SET OUT IN ANNEX III. THE FIGURES AGREED TO IN ANNEX III SHOULD FORM THE BASIS FOR ESTIMATING COSTS FOR THE 56-INCH SYSTEM.

THE PRESENT FILING SHOWS A COST INCREASE IN CONSTANT 1976 DOLLARS FOR THE 56-INCH ALTERNATIVE OVER THE 54-INCH OF \$54.3 MILLION, OR \$24 MILLION MORE THAN FOOTHILLS' FEBRUARY 27, 1978, ESTIMATE OF \$30.3 MILLION. FOOTHILLS HAS ADJUSTED ITS 56-INCH COST ESTIMATES TO YIELD ESSENTIALLY THE SAME INCREMENTAL AMOUNT THEY WERE WILLING TO ACCEPT ON FEBRUARY 27, 1978, WHICH IT KNEW AT THE TIME INCLUDED THE \$24.2 MILLION CORRECTION IN FILED BASE CASE NUMBERS.

MR. RUTHERFORD'S MARCH 3 LETTER TO YOU INDICATES THAT FOOTHILLS IS PREPARED TO DEMONSTRATE THE REASONABLENESS OF THE UNIT INCREMENTAL COSTS UTILIZED IN ARRIVING AT ITS NEWEST ESTIMATE. WE WOULD WELCOME SUCH A DEMONSTRATION, PROVIDED THE DEMONSTRATION ALSO INCLUDES A GENUINE EFFORT TO RESOLVE THE DIFFERENCES BETWEEN OUR RESPECTIVE COST

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ESTIMATES.

THE U.S. ESTIMATES WERE DERIVED FROM BASE CASE (48-INCH, 1260 PSIG) DATA SUPPLIED BY FOOTHILLS, ET AL. UNFORTUNATELY, THE DATA FROM THE THREE INDIVIDUAL FOOTHILLS COMPANIES WAS NOT INTERNALLY CONSISTENT WITH REGARD TO FORMAT, NOR WAS IT IN THE FORM WE REQUESTED. AS A CONSEQUENCE, IN OUR ATTEMPT TO OBTAIN COST ESTIMATES FOR ALL CONSTRUCTION COST ITEMS THAT WOULD VARY WITH A CHANGE IN PIPE SIZE (I.E., PIPE, DITCHING, WELDING, SWAMP WEIGHTS, ETC.), IT WAS SOMETIMES NECESSARY TO USE NUMBERS FROM ONLY ONE COMPANY. THEREFORE, WE ALMOST CERTAINLY DID NOT RECONSTRUCT THE BASE CASE NUMBERS EXACTLY AS USED BY THE INDIVIDUAL COMPANIES. WE WERE ALSO WORKING UNDER SEVERE TIME RESTRICTIONS WHICH COULD HAVE LED TO ERRORS IN INTERPRETATION AND RECONSTRUCTION.

WE ARE NOT NECESSARILY BOUND TO OUR COST ESTIMATES AND ARE WILLING TO ATTEMPT TO RESOLVE ANY DIFFERENCES. WHAT WE WILLING TO ATTEMPT TO RESOLVE ANY DIFFERENCES. WHAT WE DESIRE ARE ESTIMATES THAT ARE CLEARLY REASONABLE AND LOGICAL. SINCE OUR NUMBERS ONLY DIFFER FROM THE APPLICANTS

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LATEST ESTIMATES BY ABOUT \$19 MILLION (IN 1976 DOLLARS), WE FEEL THAT THE CHANCES OF RESOLVING DIFFERENCES IN COST ESTIMATES ARE GOOD. HOWEVER, WE ARE UNABLE TO

TIFY FOOTHILLS' LATEST COST ESTIMATES BASED ON THE
BREAKDOWN OF COST IN THEIR 'DETAILED ANALYSIS OF
INCREMENTAL CAPITAL COSTS (1976\$)" INCLUDED IN THEIR
MARCH 3, 1978, LETTER. WE REGARD THE COMPANY'S TABLE AS
ESSENTIALLY A SUMMARY, NOT A DETAILED ESTIMATE.

WHILE IT IS REASONABLY EASY TO ESTIMATE PIPE COSTS, WE DO
NOT HAVE THE CAPABILITY OF ESTIMATING PIPE INSTALLATION
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COSTS WITHOUT BREAKING SUCH COSTS DOWN INTO THEIR
COMPONENT PARTS. FOR INSTANCE, WE ARE UNABLE TO
UNDERSTAND WHY INSTALLATION COST INCREASES ARE 50 PERCENT
OF MATERIAL COST INCREASES IN ALBERTA, BUT OVER 200 PERCENT
OF MATERIAL COST INCREASES IN BRITISH COLUMBIA, AND AT
THIS JUNCTURE ARE LEFT TO SPECULATE ON DIFFERENCES IN
TERRAIN.

TO ENABLE US TO EVALUATE THE BASIS FOR COST DIFFERENCES,
WE FEEL IT WOULD BE NECESSARY TO BREAK DOWN THE APPLICANTS'
BASE CASE COST ESTIMATES INTO SUCH INDIVIDUAL COST ITEMS
AS MILL COSTS OF PIPE, PIPE TRANSPORTATION TO RAIL
TERMINALS, TRANSPORTATION TO DISTRIBUTION POINTS, DOUBLE
JOINTING, STRINGING, DITCHING, WELDING, INSPECTION,
COATING, SWAMP AND RIVER WEIGHTS, LAYING AND BACKFILLING,
ROAD AND RIVER CROSSINGS, VALVES AND FITTINGS, COMPRESSOR
STATIONS, OTHER TRANSPORTATION COSTS, AND SUPPORT COSTS.
FROM THESE, INDEPENDENT JUDGMENTS CAN BE MADE WHICH WILL
FACILITATE RESOLUTION OF DIFFERENCES IN THE ESTIMATED
COST OF CONSTRUCTING A 56-INCH LINE.

WE ARE PREPARED TO ATTEMPT TO RECONCILE COST DIFFERENCES
ON THE ABOVE BASIS. WE WERE PREPARED TO DO SO AT THE
FEBRUARY 27, 1978, MEETING IN CALGARY, ALBERTA. AT THAT
TIME FOOTHILLS DID NOT INDICATE A WILLINGNESS TO GO INTO
THE DETAIL WE THINK WILL BE NECESSARY TO REACH A THOROUGH
UNDERSTANDING OF HOW THE COST ESTIMATES WERE OBTAINED.

TO FACILITATE REACHING AN AGREEMENT ON COSTS, IT MIGHT
BE HELPFUL FOR OUR TECHNICAL PERSONNEL TO MEET INFORMALLY
WITH ENGINEERS FROM EACH COMPANY, SOLELY FOR THE PURPOSES
OF AGREEING TO THE ANNEX III 56-INCH ADDENDUM. THIS WOULD

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ALLOW US TO RECONSTRUCT PRECISELY THE BASE CASE NUMBERS
AND TO DETERMINE THE SCALING FACTORS EACH APPLICANT USED
IN ARRIVING AT THEIR RESPECTIVE INCREMENTAL COST ESTIMATES.

WE FEEL THAT IT IS LIKELY SUCH A REVIEW WOULD PRODUCE AGREEMENT, HOWEVER, THIS MIGHT TAKE CONSIDERABLE TIME.

ON THE OTHER HAND, WE RECOGNIZE THAT THE PRESENT DIFFERENCE BETWEEN OUR RESPECTIVE TOTALS IS WELL WITHIN THE LIKELY ESTIMATION ERROR, AND THE FIGURES MAY PROVE IMPERVIOUS TO FURTHER REFINEMENT. CONSEQUENTLY, WE WOULD BE WILLING TO ACCEPT THE ESTIMATED CAPITAL COSTS CONTAINED IN FOOTHILLS' MARCH 3 LETTER AS APPROVED FILED CAPITAL COSTS APPLICABLE TO THE AGREEMENT AS SET FORTH IN ANNEX III OF THE AGREEMENT BETWEEN THE U.S. AND CANADA ON PRINCIPLES APPLICABLE TO A NORTHERN NATURAL GAS PIPELINE, CONTINGENT UPON WRITTEN AGREEMENT THAT SUCH COSTS INCLUDE ALL NORMAL PIPELINE CAPITAL COSTS INCURRED AND PERMITTED TO BE RECOVERED IN CANADA, INCLUDING ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION (AFUDC), REGULATORY COSTS, ETC., EXCEPT AS SPECIFICALLY EXCLUDED IN THE AGREEMENT (I.E., WORKING CAPITAL; PROPERTY TAXES; DIRECT CHARGES FOR ROAD MAINTENANCE; AND INCREASES IN COSTS OR DELAYS CAUSED BY ACTIONS ATTRIBUTABLE TO U.S. SHIPPERS, RELATED U.S. PIPELINE COMPANIES, ALASKAN PRODUCERS, PRUDHOE BAY DELIVERABILITY, CONDITIONING PLANT CONSTRUCTION, THE UNITED STATES, OR STATE GOVERNMENTS). WE SHOULD ALSO CLARIFY THAT THE CAPITAL COST ESTIMATES IN ANNEX III FOR ZONES 1-9 ARE FOR AN INITIAL THROUGHPUT CAPACITY OF 2.4 BILLION CUBIC FEET PER DAY.

WE ARE SPECIFICALLY CONCERNED THAT THE MONITORING COSTS CHARGED TO THE PIPELINE BY THE NORTHERN PIPELINE AGENCY ARE INCLUDED IN FOOTHILLS' ESTIMATES. OUR INTERPRETATION
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IS THAT ALL NORMAL PIPELINE COSTS NOT SPECIFICALLY EXCLUDED BY THE AGREEMENT ARE INCLUDED IN FILED COSTS; THUS, MONITORING COSTS ASSOCIATED WITH CONSTRUCTION OF THE PIPELINE FACILITIES SHOULD BE INCLUDED IN FOOTHILLS' MARCH 3 FIGURES. HOWEVER, TO PREVENT POSSIBLE MISINTERPRETATION OR DISAGREEMENT, WE FEEL THAT THE CHANGE IN ANNEX III SHOULD INCLUDE A FOOTNOTE TO THE FILED CAPITAL COSTS FOR THE 56-INCH ALTERNATIVE WHICH WOULD MAKE IT CLEAR THAT THE PIPELINE MONITORING COSTS INCURRED AS THE RESULT OF SECTION 29 OF THE ACT ESTABLISHING THE NORTHERN PIPELINE AGENCY ARE INCLUDED IN THE FILED COSTS.

THERE ARE SEVERAL TECHNICAL POINTS ABOUT THIS APPROACH THAT WOULD NEED TO BE WORKED OUT IN MORE DETAIL IN THE FUTURE. MONITORING COSTS INCURRED DURING THE CONSTRUCTION PERIOD WOULD BE CONSIDERED A PART OF THE CONSTRUCTION COSTS OF THE PROJECT AND WOULD BE CAPITALIZED UNTIL RECOVERY COMMENCED THROUGH THE LEVYING OF RATES ON THE SHIPPERS. THE ALLOWANCE FOR FUNDS UTILIZED IN PAYING THESE COSTS DURING THE CONSTRUCTION PERIOD WOULD BE AT THE SAME RATE

AND ON THE SAME BASIS AS THE ALLOWANCE FOR OTHER COSTS CAPITALIZED DURING THE PERIOD. INsofar AS THE ALLOCATION OF THESE MONITORING COSTS TO THE VARIOUS ZONES, THOSE COSTS THAT ARE DIRECTLY ASSIGNABLE SHOULD BE SO ASSIGNED; THE BASES FOR ALLOCATING THE OTHER COSTS SHOULD BE EXPLAINED AND JUSTIFIED. ADDITIONALLY, ANNEX III NOTES THAT THE ACTUAL CAPITAL COSTS, FOR PURPOSES OF THIS ANNEX, WILL BE THE BOOKED COST AS OF THE DATE "LEAVE TO OPEN" IS GRANTED, PLUS AMOUNTS STILL OUTSTANDING, TO BE ACCRUED ON A BASIS TO BE APPROVED BY THE NATIONAL ENERGY BOARD (NEB).

THE LIFE OF THE MONITORING AGENCY IS TO EXTEND UNTIL ONE
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YEAR AFTER "LEAVE TO OPEN" IS GRANTED, AND IT WOULD PRESUMABLY BE CHARGING COSTS TO THE PIPELINE DURING THAT YEAR. NO DOUBT A MUTUALLY SATISFACTORY ARRANGEMENT COULD BE WORKED OUT ON THIS POINT ALSO.

IF YOU ARE NOT PREPARED TO STATE IN A FOOTNOTE IN ANNEX III THAT THE MONITORING COSTS ARE INCLUDED IN THE FILED CAPITAL COSTS PROVIDED BY FOOTHILLS IN THEIR MARCH 3 LETTER TO YOU, THEN WE WOULD FEEL COMPELLED TO REQUEST CONSULTATION BETWEEN THE TWO COUNTRIES PURSUANT TO SECTION 11 OF THE AGREEMENT ON PRINCIPLES. IF YOU CANNOT CONFIRM OUR UNDERSTANDING THAT THE MONITORING COSTS ARE INCLUDED IN "ACTUAL CAPITAL COSTS, EXCLUDING ONLY WORKING CAPITAL, PROPERTY TAXES, AND DIRECT CHARGES FOR ROAD MAINTENANCE OF UP TO \$30 MILLION IN THE YUKON TERRITORY," THEN WE HAVE TO CONSIDER THAT SUCH CHARGES ARE NOT THOSE "NORMALLY PAID BY NATURAL GAS PIPELINES IN CANADA IN ACCORDANCE WITH ACCEPTED REGULATORY PRACTICE," AND THEREFORE, UNDER SECTION 12 OF THE AGREEMENT, ARE NOT TO BE PASSED THROUGH TO U.S. CONSUMERS. IN THE COURSE OF SUCH CONSULTATIONS, WE WOULD ALSO EXPECT TO CONTINUE TO TRY TO RESOLVE OUR DIFFERENCES IN CAPITAL COST ESTIMATES BETWEEN THE 54-INCH AND 56-INCH ALTERNATIVES, IN THE MANNER DESCRIBED ABOVE.

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AN ALTERNATIVE TO EITHER OF THE COURSES OF ACTION DISCUSSED ABOVE, WHICH HAS BEEN SUGGESTED TO US BY VARIOUS REPRESENTATIVES ON THE CANADIAN SIDE, WOULD BE TO REGRESS TO THE 54-INCH SYSTEM FOR THE WHITEHORSE-TO-CAROLINE SEGMENT, IN ORDER TO AVOID EVEN A TECHNICAL CHANGE TO THE AGREEMENT. WE BELIEVE THAT THE CANADIAN SIDE SHARES OUR CONVICTION THAT THE 56-INCH SYSTEM IS SUPERIOR TO THE 54-INCH. IT SEEMS UNREASONABLE TO US TO CHOOSE A LESS DESIRABLE ALTERNATIVE IN ORDER TO AVOID CHANGING THE
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AGREEMENT; THEREFORE, WE ARE NOT PREPARED TO ACCEPT THE 54-INCH SYSTEM FOR THE SAME REASONS THE NATIONAL ENERGY BOARD REJECTED IT IN THEIR FEBRUARY 20 DECISION: POORER FUEL EFFICIENCY AND HIGHER COST OF SERVICE THAN THE 56-INCH SYSTEM.

WE HOPE THAT OUR PROPOSED ARRANGEMENTS FOR ADDING A FOOT-NOTE TO FOOTHILLS' MARCH 3 FIGURES UPON INSERTION INTO ANNEX III WILL BE SATISFACTORY TO YOU. WE FEEL THAT THIS APPROACH WOULD PROVIDE QUICK RESOLUTION ON THIS MATTER AND PROVIDE AN ADEQUATE SOLUTION TO BOTH OF OUR PROBLEMS, GIVEN THE DE MINIMUS SCALE OF OUR DIFFERENCES COMPARED TO THE TOTAL SIZE OF THE PROJECT. WE LOOK FORWARD TO A FAVORABLE RESPONSE TO OUR PROPOSAL.

END TEXT VANCE

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